United States Senate
COMMITTEE ON SMALL BUSINESS
WASHINGTON, DC 20510–6350

September 15, 1999

The Honorable Deidre Lee
Administrator, Office of Federal Procurement Policy
Old Executive Office Building
Washington, DC 20503

FAX: (202)395-3729

Dear Administrator Lee:

We understand the Department of Energy (Department) has appealed to your office for resolution of a dispute with the Small Business Administration (SBA) concerning the Department's reporting of small business contracting goals and achievements. As Chairman and Ranking Member of the Senate Committee on Small Business, which has oversight jurisdiction over small business contracting goals, we offer the following thoughts on the Department's position.

The Department holds that it should continue to include, in its small business prime contracting goals and achievements, the participation of small business in subcontracts awarded by its Management and Operating (M & O) contractors. This practice was sanctioned in a 1991 decision issued by the Office of Federal Procurement Policy (OFPP).

The Department also seeks to add subcontracts awarded by Management and Integration (M & I) prime contractors and by Environmental Restoration Management Contract (ERMC) prime contractors, on the grounds that the Department considers them comparable to M & O contracts. Finally, the Department has in the past sought to exclude salaries and expenses of M & O contractors from its calculation of total procurement dollars, arguing that such salaries and expenses are comparable to salaries and expenses of Government employees.

In every case, the Department argues that M & O contractors are essentially acting as surrogates for the Department, as stated in the 1991 OFPP decision, and that therefore these positions are consistent with that view. It is also worth noting that, in every case, acceptance of the Department's view would result in higher reported small business participation rates than would rejection of such views. We believe that the rationale underlying the 1991 OFPP decision is no longer valid, and we believe the Department's position should be rejected with respect to every point. Below, we discuss each of these points in greater detail.

[I] M & O contractors are not surrogates for the Department, and contracts awarded by M & O contractors should not be counted as prime contracts issued by the Department.

In deciding to grant the Department permission to count M & O subcontracts awarded to small business toward the Department's prime contracting goals for small business participation, the OFPP based its view on the unusually close relationship between the Department and the M & O contractors. In a March 5, 1991 letter (hereinafter referred to as the Burman letter) to SBA Administrator Susan Engeleiter, OFPP Administrator Allan Burman noted:

> First, M&O procurements are for the direct benefit of the Federal Government. Second, M&O contractors are required to follow procurement rules and policies established by [the Department] that are similar to those required of Federal Government agencies in awarding contracts. Burman letter, at 2.

We believe this situation is no longer true, and therefore the rationale of the Burman letter no longer applies in justifying the Department's current treatment of M & O subcontracts. We do not express any opinion here on whether the rationale presented in the Burman letter was valid in 1991. We do say that it is not valid in 1999, due to a distancing of the relationship between the Department and the M & O contractors. In particular, M & O contractors are no longer "required to follow procurement rules and policies. . .that are similar to those required of Federal Government agencies in awarding contracts."

[a] The Department no longer requires M & O contractors to follow the "Federal norm" in their contracting practices.

At the time the Burman letter was issued on March 5, 1991, the Department's regulations expressly imposed obligations on the M & O contractors to follow major principles of Federal acquisition policy. In turn, the Department conferred on its contracting officers the responsibility to oversee the M & O contractors' compliance.

Part 970 of the Department of Energy Acquisition Regulation (DEAR), governing the M & O contractors, explained this practice of requiring M & O contractors to follow the "Federal norm":

> Management and operating contractors' purchasing systems should produce the proper balance between the government's decision to use the experience and the expertise of these contractors in managing and operating its programs and facilities and the objectives and the attendant requisites of the Federal acquisition process. In evaluating the proper balance between commercial purchasing practices and the requisites of the Federal acquisition process a concept referred to

> as the "Federal norm" has evolved. The Federal norm refers to those fundamental principles embodied in law and regulation that should be reflected in contractor purchases even though such purchases are not Federal procurements. DEAR (1991) §970.7103(b).

The DEAR then listed some "specific tenets of Federal procurement policy that must be addressed in [an M & O] contractor's purchasing system." These specific tenets included:

> A fair proportion of supplies and services shall be purchased from small business concerns, small disadvantaged business concerns, labor surplus area concerns, and woman-owned business concerns. Publication of appropriate requirements in the Commerce Business Daily is one method that may be used to promote the participation of such concerns. DEAR (1991) §970.7103(c)(5).

The DEAR also granted authority to the contracting officers "to assure that management and operating contractors implement [the Department's] policies and requirements, as defined in this subpart [DEAR subpart 970.71], in accordance with the contractor's accepted system and methods." DEAR (1991) §970.7102(b)(3).

In 1995, four years after the Burman letter was issued, the Department abandoned this entire approach. In a final rule effective June 2, 1995, the Department deleted the DEAR's "Federal norm" requirement, including the "specific tenet" on participation by various small business concerns. The contracting officers' authority to assure M & O implementation of Departmental policies and requirements was also deleted, in favor of the Government-wide authority to consent to subcontracts under subpart 44.2 of the Federal Acquisition Regulation (FAR). The express purpose of these changes, as stated in the rule summary, was to "eliminate the application of the 'Federal norm.'" 60 Federal Register 28737 (June 2, 1995).

Because the Department no longer requires M & O contractors to follow "procurement rules and policies established by [the Department] that are similar to those required of Federal Government agencies in awarding contracts" (Burman letter at 2), the basic rationale for the Burman letter has been abandoned and the conclusion is no longer applicable. The Department should therefore report contracts awarded by M & O contractors as subcontracts, in the same manner that other agencies treat awards by contractors managing their sites.

[b] The Department no longer allows the General Accounting Office to consider protests made by a subcontractor against an M & O contractor.

The role of the General Accounting Office (GAO) in reviewing subcontractor protests provides a further testament to the closeness of the relationship between the Department and its

M & O contractors at the time of the 1991 Burman letter. The general rule at the time, as stated in the Department's regulations, was that GAO would not consider subcontractor protests unless such subcontracts were "by" or "for" the Government. Subcontracts with an M & O prime contractor were considered "for" the Government for this purpose, and GAO would therefore review protests filed by a subcontractor against an M & O contractor. DEAR (1991) §§ 933.170(a), 970.7107(a). The Department explicitly stated that it would entertain such protests as well. DEAR (1991) § 970.7107(b).

On January 31, 1995, GAO published a proposed rule revising its policies on subcontractor protests to reflect concerns raised in a recent court ruling. As a result of that ruling, GAO reclassified protests filed by subcontractors, against a prime contractor awarding a subcontract that would be "by" or "for" the Government, as nonstatutory protests--thus requiring the agency awarding the original prime contract to request in writing that GAO consider such subcontractor protests. It is worth emphasizing that GAO did not issue a blanket refusal to consider such protests; it merely stated that the Government agency would need to make a referral.

This proposed rule was not yet final when the Department incorporated this change into its policies on M & O contractors. (GAO issued its final rule, which in this respect was the same as the proposed rule, on August 10, 1995.) As part of the same ruling removing the "Federal norm" requirement (*supra*), the Department deleted all of DEAR §§ 933.170 and 970.7107 governing subcontractor protests in general and against an M & O contractor in particular. 60 Federal Register 28737 at 28740-41 (June 2, 1995). Although GAO had allowed an agency to refer subcontractor protests to it for consideration, the Department voluntarily precluded such a possibility. In response to a comment filed on the Department's rule during the public comment period, the Department stated that it did not "foresee any particular circumstances where [the Department] will request GAO subcontractor protest resolution assistance." *Id.*, at 28739. Moreover, the Department itself would no longer entertain such protests:

> The Department believes that disagreements over the award of individual subcontracts should be resolved in the same manner used by non-Federal entities and their suppliers. The Department has endorsed the contractors' use of alternative disputes resolution where appropriate. *Id.*

By eliminating review of subcontractor protests either by the Department or by GAO, the Department effectively distanced itself from the M & O contractors. Moreover, the Department's preference for resolution by processes "used by non-Federal entities and their suppliers" highlighted the Department's view that the M & O contractors were not extensions of the Government itself. This further undermines the rationale underlying the decision in the

Burman letter, and further emphasizes that M & O subcontracts should be reported as subcontracts and not as prime contracts for small business goaling purposes.

[c] The Department no longer accepts liability for actions taken by an M & O contractor.

When the Burman letter was issued in 1991, the Department and its M & O contractors maintained a much closer relationship with respect to issues of liability. Different rules governed such situations, depending on whether the M & O was a for-profit or a not-for-profit entity, but in either case the Department was much more inclined in the past to accept liability for the M & O's actions than it is today.

With respect to for-profit M & O contractors, the 1991 rule provided that the M & O must notify the contracting officer of any legal action taken against the contractor as a result of the M & O's performance of the contract and of any claim made against the M & O that might be an allowable cost payable by the Department. Upon authorization by the contracting officer, the Government's representatives would settle or defend the claim on behalf of the M & O, and if the M & O were held liable, "the resulting claim or damages shall be at the expense of the Government." If the contracting officer withheld such authorization, however, the M & O would proceed on its own and the Government would not be liable. DEAR (1991) §970.5204-31, Note 2. Generally, in cases involving for-profit M & O contractors, the Government's liability was at the discretion of the contracting officer.

In cases involving non-profit M & O contractors, the likelihood the Government would be liable was greater. As with the for-profit M & O contractors, the Government could undertake the defense of the claim filed against the non-profit M & O, if the contracting officer authorized it. However, if the contracting officer did not authorize the Government to defend the action, the M & O contractor could do so. In either case, the defense of the claim would be at Government expense. *Id.*, at Note 1. Thus, the contracting officer's decision whether to defend the action by the Government itself did not affect whether the claim would be payable by the Government.

The current rule, adopted June 27, 1997 (62 Federal Register 34841), signficantly disentangled the Government from its M & O contractors. It adopted a "rebuttable presumption" that certain costs are unallowable for reimbursement under the contract. As the Department explained in publishing its proposed rule on June 24, 1996:

> A key change in today's notice of proposed rulemaking would be the adoption of a rebuttable presumption of unallowability standard for fines and penalties, third-party liability, and damage to or loss of government property. This standard, which would affect a number of contract clauses governing the Department's management and operating contracts, would shift the burden of proof for establishing the reasonableness

> and allowability of these costs from the Government to the contractor. An underlying premise in promulgating this change in policy is the belief that the contractor has in its possession the information necessary to determine how and why these costs are incurred and, therefore, is better able to establish the facts and other information needed to support a decision of allowability. Accordingly, under this proposed rule, the contractor would have to make an affirmative showing to the contracting officer that such costs should be allowable. 61 Federal Register 32588 at 32589 (June 24, 1996).

This rebuttable presumption was retained in the final rule. 62 Federal Register 34841 at 34866 (June 27, 1997). In addition, the liability of the M & O contractors to third parties (such as subcontractors) was expressly made non-reimbursable if the M & O contractor's management had engaged in willful misconduct, lacked good faith, or failed to exercise prudent business judgment. *Id.*, at 34868.

These changes effectively distanced the Department from its M & O contractors. The new rules recognize that an M & O contractor could engage in willful misconduct, fail to act in good faith, or fail to exercise prudent business judgment, and these actions would be independent of the Department and non-reimbursable by it. This further undermines the rationale of the 1991 Burman letter. The M & O contractors, therefore, are not instrumentalities of the Department, and contracts awarded by the M & O contractors should not be counted as prime contracts awarded by the Department for its small business goals.

[II] Contracts awarded by M & I and ERMC contractors should not be counted as prime contracts awarded by the Department.

The Department maintains that M & I contractors and ERMC contractors are analogous to M & O contractors. Therefore, contracts awarded by such contractors should be counted in the Department's prime contracts awards, as contracts awarded by M & O contractors are counted currently.

However, given the change in circumstances affecting the M & O contractors, as discussed previously, the 1991 Burman letter no longer has a valid rationale. Since subcontracts awarded by M & O contractors should be counted as subcontracts, this is also true for the M & I and ERMC contractors. This will keep the Department's small business goals and achievements comparable to goals and achievements reported by other agencies.

It is worth noting, however, that when the Department sought public comment on its proposed rule removing the consideration of subcontractor protests from GAO and eliminating the "Federal norm" in M & O contracting, it received a public comment suggesting that the

Department clarify the relationship of DEAR Part 970, " DOE Management and Operating Contracts," to the ERMC contractors. The commenter suggested making Part 970 more broadly applicable and that it be renamed "Prime Contractors." The Department rejected this suggestion, noting that its final rule "does not apply to environmental restoration management contracts, or any other non-M&O contract." The Department did not elaborate on its decision, but its action clearly indicates that the Department sees ERMCs and "any other non-M&O contract" as substantially different from M & O contracts. 60 Federal Register 28737 at 28738 (June 2, 1995).

Now the Department wishes to argue that M & I and ERMC contracts are essentially comparable to M & O contracts. The Department cannot have it both ways.

[III] Employees of M & O contractors are not Government employees, and their salaries and expense costs should be included in the Department's procurement statistics.

In April 1998, the Department's Inspector General released a report, "Report on Inspection Regarding Small Business Contracting, Statistics Reporting, and Presentation," (hereinafter "Inspector General's Report") which found that the Department had changed its treatment of M & O contractor salaries and expenses in its small business statistics reporting. Specifically, the Department excluded these salary and expense costs from its total procurement volume in reporting its small business contracting achievements for Fiscal 1994 and its goals for Fiscal 1995. This change materially affected the Department's small business statistics, increasing its apparent achievements and goals.

By excluding these costs from the procurement base, the Department appeared to increase substantially the percentage of contract dollars being awarded to small business. However, this was a statistical artifice. These percentages are calculated by dividing the total prime contract dollars awarded to small business by the total prime contract dollars; a reduction in the total prime contract dollars (the denominator) artificially increases the percentage represented by the small business prime contracts (the numerator). In the Department's case, this statistical change increased the reported small business achievements to 35.4% in Fiscal 1994; the Inspector General indicated that including M & O contractor salaries and expenses in the denominator, as had been done in the past, resulted in an actual achievement of 19.5% in Fiscal 1994. Inspector General's Report, at 10-13.

The Department argues that, since M & O contractors act as extensions of the Government, their costs for their salaries and expenses should be considered equivalent to salaries and expenses for Government employees and excluded from the Department's statistics on total procurement dollars. However, the Federal Acquisition Regulation (FAR) expressly notices a distinction between contractor employees and Government employees. Most notably,

the FAR requires that contractor employees not engage in inherently governmental functions. These are defined as including "activities that require either the exercise of discretion in applying Government authority, or the making of value judgments in making decisions for the Government." FAR §7.501.

Because contractor employees are not permitted to engage in inherently governmental functions, they must be overseen by Government employees who can carry out such functions. This means that contractor employees, including M & O contractor employees, are not replacements for Government employees and are not interchangeable, as the Department implies. It is deeply disturbing to hear an agency argue that, in some cases such as small business statistics reporting, contractor employees should be treated as Government employees. This can only confuse and obscure the public policy with respect to contractor employees.

Salaries and expenses incurred by M & O contractors are not equivalent to Government employee salaries and expenses, and are legitimately reported as procurement costs. Acceptance of the Department's position would tend to obscure the dividing line between Government and contractor employees and would tend to undermine the policy against delegating inherently governmental functions to contractor employees. It should be categorically rejected.

Conclusion

We are aware that requiring subcontracts awarded by M & O contractors to be reported as subcontracts would result in a substantial apparent reduction in the Department's small business achievements. We do not wish to subject the Department to unfair criticism. In legislation adopted in committee last summer (and subsequently approved by the full Senate), the Senate Committee on Small Business took the position that it disfavors sudden unexplained changes in small business statistics that result purely from methodological changes. However, we believe this can be addressed by including a prominent disclosure of the change in The State of Small Business, the Department's annual small business report to Congress, and any other report on the Department's small business program.

We take very seriously the prospect of generating any unfair criticism or undue confusion about the Department's small business efforts. Since we also believe this problem can be avoided with a prominent disclosure, we believe this concern is outweighed by the public policy concerns that necessitate the change. The Department's contracting goals and achievements should be reported in the same manner and on the same basis as all other agencies of the Government. Granting waivers (such as the 1991 Burman letter) to the Department undermines the validity of the Government-wide statistics and impedes our ability to conduct appropriate oversight. After all, we will be unable to set realistic goals if an agency is permitted to use statistical legerdemain to give the mere appearance of success without the actual reality of success.

Thank you for your thoughtful consideration of our views on this situation. Should you have questions about our perspective, please feel free to contact Cordell Smith of the Majority Staff on (202)224- or Damon Dozier of the Minority Staff on (202)224- .

Sincerely,

Christopher S. Bond
Chairman

John F. Kerry
Ranking Member

cc: The Honorable Aida Alvarez
Small Business Administration